93-489

No. ——

IN THE
Supreme Court of the United States

OCTOBER TERM, 1993

O'MELVENY & MYERS, A LAW PARTNERSHIP,
Petitioner,
v.

FEDERAL DEPOSIT INSURANCE CORPORATION AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK, ADC FINANCIAL CORPORATION, AMERICAN DIVERSIFIED/ WELLS PARK II, and AMERICAN DIVERSIFIED/GATEWAY CENTER,
Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether federal common law authorizes the Federal Deposit Insurance Corporation, suing as receiver of an insolvent savings bank, to pursue tort claims against third parties in situations where the bank itself would have been estopped from bringing suit.

2. Whether, in a lawsuit brought by the Federal Deposit Insurance Corporation as receiver of an insolvent savings bank, it is proper to use a federal rule of decision in determining what tort claims the bank would have had against third parties prior to the receivership.

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Petitioner O'Melveny & Myers respectfully prays that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Ninth Circuit in this matter.[1]

[1] The sole parties to this case are reflected in the caption. The lawsuit was actually filed by the Federal Savings & Loan Insurance Corporation ("FSLIC"), but the designation of the plaintiffs was changed in 1990 to the Federal Deposit Insurance Corporation

OPINIONS BELOW

The opinion of the Court of Appeals for the Ninth Circuit is reported at 969 F.2d 744, and is reprinted in the appendix hereto at 1a-16a. The decision of the United States District Court for the Central District of California is not reported. The court's oral ruling and subsequent order are reprinted in the appendix at 17a-19a and 20a-21a.

JURISDICTION

The Ninth Circuit issued its decision on June 29, 1992. A timely petition for rehearing was denied on June 30, 1993. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

None.

STATEMENT

This case involves a claim of legal malpractice brought against the law firm of O'Melveny & Myers ("O'Melveny") by the Federal Deposit Insurance Corporation ("FDIC") as receiver of the American Diversified Savings Bank ("ADSB"). It arose from work that was performed by O'Melveny for ADSB in late 1985, assisting in the preparation of two private placement memoranda for circulation to potential investors in real estate syndications. At that time, Ranbir Sahni, who was ADSB's Chairman and owned 96 percent of its stock, and Lester Day, who was the bank's President and owned the balance of the stock, were engaged with others in a fraudulent effort to hide the fact that ADSB was in precarious financial condition. That effort included intentional overvaluation of assets, sham sales of assets, and other financial irregularities. These facts were not disclosed to O'Melveny, however, and thus were not discussed in the private placement memoranda that the firm helped to prepare.

("FDIC"). For the sake of clarity and simplicity, we refer throughout this petition to respondent as the "FDIC."

On February 14, 1986, the FDIC stepped in as conservator for ADSB, removed Sahni, Day, and their fellow officers and directors, and installed new management. Within a few days, the FDIC sued Sahni and Day for over $70 million for fraud, misrepresentation, mismanagement, and breach of fiduciary duty. It thereafter caused ADSB to rescind the two private placements, repaying the sums previously invested. ADSB was liquidated in June 1988.

On May 12, 1989, the FDIC, acting as ADSB's receiver, filed suit against O'Melveny alleging legal malpractice and seeking damages on behalf of ADSB and the investors. First asserting a breach of duty to ADSB, the FDIC charged that O'Melveny should have discovered the true facts about ADSB's management and financial condition, and advised the bank of the bank's own fraud and the consequences that would flow from it. In addition, the FDIC asserted that O'Melveny breached a duty to the investors in the real-estate syndications by failing to disclose the problems at ADSB in the private placement memoranda.[2]

After the FDIC and O'Melveny agreed to a stipulated record (solely for the purposes of summary judgment), the United States District Court for the Central District of California granted summary judgment for O'Melveny. In a brief oral decision, the court ruled that O'Melveny had no duty to ADSB to discover and disclose to ADSB its own fraudulent activities, and that any claims the investors might have had (which were previously assigned to ADSB) were extinguished through repayment via the rescission.

[2] In the opinion below, the Ninth Circuit focused entirely on the FDIC's claim brought on behalf of ADSB, evidently because the investors had been fully repaid and the FDIC was "not seeking reimbursement for the rescission payments to the investors." Pet. App. 15a. Accordingly, petitioner here addresses only ADSB's claims.

The FDIC appealed. In the Ninth Circuit, O'Melveny contended that, since ADSB's controlling officers and directors and all of its shareholders had full knowledge of their own fraudulent efforts to conceal ADSB's real financial condition, and had attempted, successfully, to conceal those activities from O'Melveny, the law firm could not have been held liable to ADSB for failing to discover and disclose this fraud. The firm also argued that if ADSB had no cause of action, the FDIC could have no greater rights, since it was suing as the receiver of ADSB's claims and liabilities.

The Ninth Circuit reversed. To begin with, the court ruled that petitioner had a duty to discover its client's fraudulent activities. In such a situation, the court stated, a lawyer is required to "advise the client and the world" of the client's fraud. Pet. App. 7a. The court rejected the notion that a client's own intentional misconduct "cancels the attorney's duty to use due care" and to advise his client that its conduct will redound to its own detriment by causing public harm. *Id.* at 8a.[3]

The court then turned to the question whether ADSB would have been estopped from suing O'Melveny because its top officers and 100-percent owners were fully aware of their own fraudulent conduct. It held that estoppel did not apply. In so ruling, the court relied on a federal rule—citing principally federal cases applying federal law and the law of states other than California for the proposition that Sahni's and Day's conduct was sufficiently "adverse" to the interests of ADSB to prevent imputation of their knowledge to the bank. *Id.* at 12a ("[C]onduct aggravating a corporation's insolvency and fraudulently prolonging its life does not benefit that corporation.").

[3] This aspect of the Ninth Circuit's decision is not raised as a basis for this petition because it appears, at least arguably, to rest on California law. The court invoked "the general rule that a lawyer has to act competently to avoid public harm when he learns that his is a dishonest client" (Pet. App. 8a), and stated that "[n]o California cases advise us of an exception to th[is] general rule," *ibid.* The ABA's Working Group on Lawyers' Representation of Regulated Clients has called the Ninth Circuit's "general rule" a "novel theory" of attorney malpractice. *See Laborers in Different Vineyards? The Banking Regulators and the Legal Profession* 129-30 (Discussion Draft, Jan. 1993).

Finally, the Ninth Circuit held, in the alternative, that any estoppel defense applicable to ADSB would not in any event be applicable to the FDIC. The court stated that "federal, not state, law governs the application of defenses against [the] FDIC." *Id.* at 13a (citing *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447, 456 (1942), and several lower court decisions). The court acknowledged that it was authorized to "incorporate state law to provide the federal rule of decision," *id.* at 13a-14a, but concluded, without explanation, that it "must instead establish federal law [here]," *id.* at 14a.

In fashioning its new federal rule, in turn, the court relied entirely on its own notions of "equity." *Id.* It pointed out that a receiver differs from a normal successor in interest, who takes over a bank's assets voluntarily and "can adjust the purchase price for the diminished value of the bank's assets due to their associated equitable defenses." *Id.* Providing a fiscal rationale for its new rule, the Ninth Circuit, after taking note of the "intricate [federal] regulatory scheme designed to protect the interests of third parties," held that the federal regulation of savings and loan institutions was "designed to protect the interests of third parties . . . [and] would be frustrated by imputing the bank's inequitable conduct to the receiver, thereby diminishing the value of the asset pool held by the receiver and limiting the receiver's discretion in disposing of the assets." *Id.* at 15a.

REASONS FOR GRANTING THE WRIT

The central issue in this case is whether federal common law grants the FDIC, acting as receiver of a failed savings bank, the right to pursue tort claims against law-

yers previously retained by the bank, based on the theory (not available to the bank under state law) that these lawyers should have discovered the fraud and disclosed it to the perpetrators of the fraud—the bank's own controlling officers and directors. The Ninth Circuit, applying newly created federal common law rather than borrowing the applicable state law concerning the rights of receivers, ruled that the FDIC could pursue such a claim against O'Melveny, even if ADSB itself would have been estopped from doing so. The court also held in the alternative, adopting a federal rule of decision drawn largely from federal RICO cases, that the bank itself would not have been estopped from bringing such a claim, because the knowledge of its owners and managers would not have been imputed to the bank as a corporate entity.

These rulings warrant review by this Court for two reasons. First, as the FDIC has acknowledged, the Ninth Circuit's decision here and the Fifth Circuit's decision in *Ernst & Young*, 967 F.2d 166 (1992)—the leading cases in this area—are squarely in conflict. That conflict involves an issue of critical legal and practical importance —the manner in which federal courts are to address third-party tort liability claims in the wake of bank failures. Immediate resolution of this circuit conflict is essential, because courts all over the country are now faced with the question of what law to apply in deciding whether to allow the FDIC to proceed with massive tort claims against accounting and law firms previously retained by failed banks and savings institutions. *See, e.g.*, Adams, *Thrift Litigation Fallout; Suits Increasing; Firm Grip on Lawyers Sought*, N.Y. L.J., June 18, 1992, at 5; Boyle, *FDIC Steps Up Probes of Lawyers*, Mass. Law. Wkly., Mar. 25, 1991, at 1. A central threshold issue in these cases will be the extent to which the FDIC's involvement can breathe life into tort claims that a bank otherwise could not have brought.[4]

[4] This important conflict has already prompted substantial legal commentary. *See, e.g.*, Sontag, *Circuits Split on Regulators' S&L Malpractice Claims*, Nat'l L.J., Aug. 17, 1992, at 17 ("Conflicting decisions from the 9th and 5th Circuits have left regulators and professionals who advise the banking industry uncertain over the viability of malpractice claims when the federal government becomes a receiver. . . . With so many failed [financial] institutions in Texas and the Pacific northwest, the battle is likely to affect the outcome of dozens of pending and future cases."); Arnoff & Klampert, *Regulatory Malpractice and Causation Analysis—Part I*, N.Y. L.J., Oct. 29, 1992, at 3 ("[The] two federal courts cases indicate a conflict in the circuits that may be resolved by the United States Supreme Court . . ."); Dennis & Fabrizio, *No Place to Hide*, The Recorder, Oct. 19, 1992 at, 10, 11 ("Without making reference to . . . *O'Melveny* . . ., the Fifth Circuit addressed the same issue—and came to the opposite conclusion."); *Laborers in Different Vineyards, supra*, at 124 ("Perhaps the most significant development in the area of malpractice litigation brought by the FDIC and RTC against attorneys is the position recently taken by the FDIC in several different cases on the question of which rule of decision—state law or federal common law—applies in such litigation.").

Second, the Ninth Circuit's approach in this case was fundamentally wrong. The court had no justification for applying judge-made federal common law to decide this case, in complete disregard of well-developed principles of state tort law that had previously formed the basis of the relationship between a law firm and its client.[5] It is true that cases involving the FDIC are "deemed to arise under the laws of the United States," 12 U.S.C. § 1819(b)(2),

[5] *See Laborers in Different Vineyards, supra*, at 123-24 ("the new liability theories [of the FDIC and RTC] strain or ignore established principles and parameters of the attorney-client relationship . . . . Under some of the theories, counsel would appear to have responsibilities not only to their institutional client but also unprecedented responsibilities to the government regulators and the public at large. The new liability theories are sometimes advanced by the agencies under the rubric of 'federal common law' as a means of overcoming established state law and precedents allowing imputation to a bank (and, by extension, to the federal regulatory agency as its successor-in-interest) the wrongdoing of bank officers, directors, and shareholders. By avoiding such imputation, the federal receivers are able to foreclose the availability of traditional malpractice defenses such as fraud and contributory negligence.") (footnote omitted).

but that does not mean that courts are free to create new federal common law in deciding every issue. Rather, under this Court's precedents, the lower federal courts are presumptively required, for reasons of federalism and stability in the law, to borrow the applicable rule of state law. *See, e.g., Kamen v. Kemper Fin. Servs., Inc.*, 111 S. Ct. 1711, 1717 (1991).

Here, California law plainly provides that a receiver has no greater rights than the predecessor entity. California courts, in turn, would also hold that, under state law, ADSB was estopped from suing O'Melveny. If these rules were applied to this case, the FDIC's claim would be barred. But the Ninth Circuit did not bother even to ascertain the applicable state law—instead proceeding directly to apply its own preferred *federal* rules of decision in resolving both of these issues. *See* Pet. App. 13a. ("The flaw in [O'Melveny's] argument is the law O'Melveny assumes applies.").

It did so, moreover, without a convincing demonstration that these uniform federal rules were required to promote any unique federal interests. Stripped to its essence, the Ninth Circuit's analysis reflects little more than an explicit commitment to maximizing the funds recovered by the FDIC from every available party. *See* Pet. App. 15a ("imputing the bank's inequitable conduct to the receiver . . . [would] diminish[] the value of the asset pool held by the receiver"). But that can hardly be a sufficient basis for a ruling that, by "federalizing" tort law, dramatically altered O'Melveny's legal position after the fact. The conduct of attorneys, it is well recognized, is principally a matter of concern to the sovereign that licenses them and the state judiciary that supervises them. *Cf. Goldfarb v. Virginia State Bar*, 421 U.S. 773, 792 (1975). Yet, at least in the area of banking, the Ninth Circuit has fundamentally altered the legal responsibilities that lawyers have to their clients in a way that will directly affect their day-to-day practice. This Court should rebuff

such federal excursions into an area where "private parties have entered legal relationships with the expectation that their rights and obligations would be governed by state-law standards." *Kamen*, 111 S. Ct. at 1717.

I. THE DECISION BELOW SQUARELY CONFLICTS WITH RULINGS FROM THE FIFTH CIRCUIT.

The Ninth Circuit's rulings in this case conflict directly with the Fifth Circuit's decision in *FDIC v. Ernst & Young*, 967 F.2d 166 (1992), which was later followed in *FDIC v. Shrader & York*, 991 F.2d 216, 221-26 (5th Cir. 1993). The FDIC expressly acknowledged the conflict in its rehearing petitions in both *Ernst & Young* and *Shrader & York*. FDIC's Suggestion for Rehearing *In Banc* [in *Ernst & Young*], at 10 (the "panel's holding [in *Ernst & Young*] places the opinion in direct conflict with the Ninth Circuit's recent opinion in *O'Melveny*"); FDIC's Petition for Rehearing [in *Shrader & York*], at 6 ("The panel's holding [in *Shrader & York*] is in direct conflict with the Ninth Circuit's opinion in *O'Melveny*."). This conflict, which extends to both of the issues raised in this petition, needs to be resolved by this Court.

A. The existence of the conflict is clear and, as noted, undisputed. The Ninth Circuit held that the FDIC is not barred by a state-law estoppel defense that would have prevented a failed savings bank from suing its own former counsel. Implicitly acknowledging that a receiver under California law has no greater rights than were possessed by the corporation prior to receivership, the court nevertheless held that it was not "bound" to apply state law in determining the FDIC's rights. Pet. App. 14a. Then, citing little more than its own notions of "equity" and a policy of maximizing the FDIC's fisc, the court proceeded to establish a new federal rule exempting the FDIC from a defense that would have barred a suit against O'Melveny by ADSB. *Id.* at 14a-15a.

In *Ernst & Young*, by contrast, the Fifth Circuit expressly rejected the FDIC's argument that, when it acts

as receiver of a failed financial institution, federal common law allows it to assert tort claims that would have been unavailable to that institution prior to the receivership. The court refused to conclude that the FDIC is "entitled to special protection when it brings a tort claim against a third party on behalf of a defunct financial entity," explaining that "[n]o statutory justification or public policy exists to treat the FDIC differently from other assignees" of claims previously possessed by financial institutions. 967 F.2d at 170.

The Ninth Circuit's alternative holding—that the estoppel defense would not even have applied to ADSB itself, prior to the receivership, and thus cannot bar suit by the FDIC—is also irreconcilable with *Ernst & Young*. The primary reason, here again, is that the Ninth Circuit chose to disregard settled state-law principles. The FDIC has repeatedly insisted—both in the Ninth Circuit and in the Fifth Circuit—that federal law governs this issue. *See* pp. 12-13 *infra*. And, while the text of the *O'Melveny* opinion is not altogether clear, the fairest reading is that, in deciding whether the knowledge of the two shareholders and officers of ADSB should be imputed to the savings bank itself, the court acepted the FDIC's invitation and applied a *federal* rule of decision, rather than borrowing the state rule.

This reading is supported by the fact that the court gave scant attention to the relevant California decisions, choosing instead to rely primarily on *Schacht v. Brown,* 711 F.2d 1343 (7th Cir.), *cert. denied,* 464 U.S. 1002 (1983), a RICO case applying federal common law to this question,[6] and on other federal cases from other circuits that applied the law of other states. Pet. App. 11a-12a. The court did cite one California case, along with several non-California cases, when it articulated the nearly

[6] The court stated that the *Schacht* decision had been "followed by this Circuit" in another RICO case, *Kempe v. Monitor Intermediaries, Inc.*, 785 F.2d 1443, 1444 (9th Cir. 1986). Pet. App. 12a.

universal rule that the knowledge of a corporate officer is not imputed to the corporation where the agent is acting adversely to the principal. Pet. App. 11a. But when it then turned to the specific problem of how that universal rule applies here—*i.e.*, whether the top officers of a savings bank are treated as benefiting or injuring that bank when they engage in "conduct aggravating [the bank's] insolvency and fraudulently prolonging its life"—the court made no reference whatsoever to California law. *Id.* at 12a.

Had it done so, the court would have had to take note of the distinction drawn in California decisions between (1) cases where an agent defrauds the principal (and no imputation applies) and (2) cases like this one where an agent, for his own benefit, defrauds *third parties* on behalf of the principal (and imputation does apply).[7] *Compare Meyer v. Glenmoor Homes, Inc.*, 54 Cal. Rptr. 786, 801 (Ct. App. 1967) ("A corporation is not chargeable with the knowledge of an officer who collaborates with an outsider to defraud it."), *with West American Fin. Co. v. Pacific Indem. Co.*, 61 P.2d 963, 969 (Cal. Ct. App. 1936) (noting that an officer acting for a corporation in a transaction, even if he has an opposing personal interest, has a duty to communicate material facts to the corporation and holding that, "[i]n such case the law will presume in favor of third persons that he made such communication; and it is immaterial that he took some personal benefit from the fraud"). The Ninth Circuit did not even acknowledge this dispositive state-law distinction, nor did it otherwise indicate that it was attempting to ascertain, and borrow, California law.

[7] The troubling nature of the court's analysis is underscored by the fact that another panel of the Ninth Circuit has held, in a case also involving the FDIC, that the defrauding owners of ADSB were the bank's alter egos. *See California Union Ins. Co. v. American Diversified Sav. Bank*, 948 F.2d 556 (9th Cir. 1991).

The FDIC, for its part, both recognized that the Ninth Circuit based its ruling on federal law and argued that it was correct in so doing. Specifically, in opposing rehearing in *O'Melveny*, the FDIC defended the panel decision on the question of imputation of the officers' knowledge to ADSB, in these terms:

> *As this Court correctly found, federal law governs.* It is the law of the Circuit, as held in *Kempe v. Monitor Intermediaries*, 785 F.2d 1443 (9th Cir. 1986), that imputation is to be determined under the test of *Schacht v. Brown*, 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983). This Court correctly applied the *Schacht* test in this case and held that the wrongdoing of two individuals should not be imputed to ADSB.

FDIC Response to Petition for Rehearing and Suggestion for Rehearing En Banc, at 4 (October 5, 1992) (emphasis added). Given that view, coupled with the language of the opinion, the Ninth Circuit's imputation/estoppel ruling is properly interpreted as having been based on federal law. *Cf. Michigan v. Long*, 463 U.S. 1032 (1983) (requiring state courts to include a clear statement that a decision is based solely on state law before Supreme Court will conclude that it rests on an adequate and independent state ground).

The Fifth Circuit in *Ernst & Young*, by contrast, clearly applied *Texas* law in determining the imputation/estoppel issue.[8] It thus concluded that any negligence exhibited

[8] In one brief filed in *O'Melveny*, the FDIC took the Fifth Circuit to task for applying state, rather than federal, law to this issue in *Ernst & Young*. *See* FDIC Response to Petition for Rehearing and Suggestion for Rehearing En Banc, at 3-4. ("The Fifth Circuit's imputation analysis also ignored the fact that federal—not state—law applies to the FDIC. . . . Although the *Schacht* case was extensively briefed to the Fifth Circuit, that Court failed even to refer to it.").

by Ernst & Young in performing its audits was not actionable because, under Texas law (like California law), knowledge of the bank's true financial condition possessed by the bank's sole shareholder was properly imputed to the bank itself (and ultimately to the FDIC as the bank's receiver). 967 F.2d at 170-71 ("In Texas, whether an employee's fraud is attributable to a corporation depends on whether the fraud was on behalf of the corporation or against it.")[9]

These conflicts between the Fifth and Ninth Circuits were, if possible, made even sharper when the former court issued its decision in *Shrader & York*. That case, like this one, involved a claim of legal malpractice against a law firm involved in various transactions on behalf of a savings and loan association that later failed and went into receivership. As in this case, but unlike in *Ernst & Young*, the FDIC purported to sue not only on behalf of the failed bank but also on behalf of depositors and creditors. *See* 991 F.2d at 223. But the Fifth Circuit once again held that the FDIC stands in the shoes of the savings banks for purposes of application of any defenses based on the imputed knowledge of the prior owners and officers. *Id.* at 222-23. And it again applied Texas law in determining that, on the facts presented, such knowledge should indeed be imputed to the savings banks and, derivatively, to the FDIC. *Id.* at 223-27.

Finally, we note that there appears to be a partial conflict between the decision below and relevant decisions of the Tenth Circuit. That court has now twice held, albeit without extensive analysis, that the rights of the FDIC as plaintiff are no greater than the rights that would

[9] In both *Ernst & Young* and *Shrader & York* the FDIC argued that because "[t]he national deposit insurance program presents a uniquely federal interest," federal law should govern whether the pre-takeover conduct of officers is imputed to the bank. FDIC Appellant's Brief in *Ernst & Young* at 22 n.9; *see* FDIC Appellant's Brief in *Shrader & York* at 26 n.22.

have been available to the bank prior to the receivership. *See FDIC v. Clark*, 978 F.2d 1541, 1550 (10th Cir. 1992) ("The [district] court properly instructed that if an employee was acting within the scope of his authority then his fault would be attributed to the FDIC, standing in the shoes of the bank."); *FDIC v. Ferguson*, 982 F.2d 404, 407-08 (10th Cir. 1991) ("Home [Savings and Loan Association] originally instituted this action when it was solvent, when the case was simply one between an attorney and his client. The FDIC's stepping in after nearly three years of litigation, asserting the taxpayers' loss as guarantor of insured deposits, does not transfer the case into the realm of the public interest.") That view is inconsistent with the Ninth Circuit's holding that the FDIC has greater rights than the bank itself.

B. These conflicts warrant review by this Court. There are literally hundreds of similar lawsuits by the FDIC pending in federal courts around the country. The district courts have already begun to choose sides between the Ninth Circuit's view in *O'Melveny* and the Fifth Circuit's view in *Ernst & Young* and *Shrader & York* with respect to the FDIC's authority to bring claims that would not have been available to the financial institution prior to receivership.[10] As a practical matter, moreover,

[10] District courts following or anticipating the Fifth Circuit's approach include *RTC v. Deloitte & Touche*, Civil No. 3-92-90, [May 28, 1993] 2 Bank Lawyer Liability (Buraff) at G-45 (D. Minn. May 7, 1993); *FDIC v. Thompson & Knight*, 816 F. Supp. 1123, 1128-29 (N.D. Tex. 1993); *FDIC v. Gantenbein*, 811 F. Supp. 593 (D. Kan. 1992); *FDIC v. Regier, Carr & Monroe*, No. 92-072-S, 1992 U.S. Dist. LEXIS 14564 at *8 (E.D. Okla. Aug. 17, 1992), *aff'd on other grounds*, 996 F.2d 222 (10th Cir. 1993); *FDIC v. Cherry, Bekaert & Holland*, 742 F. Supp. 612, 613-15 (M.D. Fla. 1990); *FDIC v. Clark*, Civil Action No. 88-F-647, 1989 U.S. Dist. LEXIS 17556 (D. Colo. March 23, 1989).

District courts relying on and following the Ninth Circuit's approach in *O'Melveny* include *RTC v. Farmer*, 823 F. Supp. 302, 311-12 (E.D. Pa. 1993); *In re Sunrise Sec. Litig.*, 818 F. Supp. 830,

the choice made by each of these courts is "crucial, especially because the ability to sustain or thwart motions for summary judgment in banking cases often decides the outcome." Sontag, *supra*, at 17.

There is no possibility that this conflict will ameliorate or dissipate. Its existence has been brought to the attention of both the Fifth and the Ninth Circuits in rehearing filings, and neither court has shown any inclination to reconsider its rulings. And the FDIC, which is a party to all of these cases, is sure to press its expressed view that the Ninth Circuit correctly decided both disputed issues on the basis of federal law, and that those federal law rulings—rather than the Fifth Circuit's state law holdings—should be followed in all FDIC cases. Finally, as we discuss in the next section of this petition, there are persuasive reasons for concluding that the Ninth Circuit's ruling is fundamentally misguided, and will have unfortunate consequences in those jurisdictions where it is applied. The legal relationship between attorney and client is a core matter for state law to control, and that law should not be displaced by federal law simply because the federal courts either do not like the state law rule or see a need to enhance the FDIC's ability to obtain funds from all parties who were ever retained by banks that subsequently failed.

II. THE NINTH CIRCUIT'S RULINGS MAKE NO SENSE AND WILL HAVE PERNICIOUS CONSEQUENCES.

On the merits, it is difficult to defend the Ninth Circuit's decision in this case. It rests largely on a transparent attempt to locate an additional "deep pocket" to help cover the government's obligations as insurer of the bank-

836-40 (E.D. Pa. 1993); *FDIC v. Benjes*, 815 F. Supp. 1415, 1417-18 (D. Kan. 1993); *Comeau v. Rupp*, 810 F. Supp. 1127, 1137-44 (D. Kan. 1992); *FSLIC v. McGinnis, Juban, Bevan, Mullins & Patterson, P.C.*, 808 F. Supp. 1263, 1272-75 (E.D. La. 1992).

ing and thrift industries.[11] In pursuit of that goal, the court of appeals (1) adopted a very expansive understanding of the "duty" owed by counsel to a client institution, (2) determined under federal law that this duty could have been enforced by ADSB, and (3) held that, in any event, under its newly fashioned federal common law, the FDIC is exempt from state-law defenses that would have applied to ADSB. In essence, the court took the position that state law becomes irrelevant whenever it impairs the uniform federal interest in maximizing the FDIC's recoveries from third parties.

The problems with the Ninth Circuit's decision have not gone unnoticed. Commentators have expressed both criticism of the Ninth Circuit's legal analysis and great concern about the practical effects of this ruling. *See* Hazard, *Ethics*, Nat'l L.J., Aug. 3, 1992, at 15, 17 ("The[] possibilities [suggested by *O'Melveny*], if they are fulfilled, would put the Kaye Scholer contretemps into the shade."); Arnoff et al., *supra* (Ninth Circuit's "analysis is critically flawed"); Brodsky, *Accountant's Liability: Erasing History*, N.Y. L.J., Mar. 11, 1993, at 3 (*Ernst & Young* is "a common-sense, well principled decision contradicting *O'Melveny & Myers*"); Brodsky, *Liability of Attorneys*, N.Y. L.J., Oct. 14, 1992, at 3 ("[T]he [Ninth Circuit] decision . . . is result oriented," with the outcome hinging "upon the identity of the plaintiff rather than the merits of the case"); Donovan, *ABA Task Force Pushes for Freeze on OTS' Powers*, Nat'l L.J., Feb. 22, 1993, at 17 ("The regulators [as a result of O'Melveny] 'want essentially to deputize the private bar' as their investigators") (quoting member of ABA Task Force).

[11] *See Laborers in Different Vineyards*, *supra*, at 124-25 ("The FDIC as receiver has . . . argued in several circuits that the courts should reject state law and, instead, create federal common law because such a rule of decision 'best serves the Congressional goal of maximum recovery for the FDIC.'") (footnotes omitted).

These important concerns should be addressed by this Court.

A. With respect to the question whether the FDIC is immune from application of an estoppel defense that would have applied to ADSB, the Ninth Circuit was, of course, correct in holding that this is a federal *question*. Pet. App. 13a-14a. *See* 12 U.S.C. § 1819(b)(2) (providing that cases to which the FDIC is a party are "deemed to arise under the laws of the United States"). But that does not mean that the court was correct in going ahead and fashioning a unique federal rule of decision. This Court has made clear that, in applying federal common law, the lower courts should adopt uniform federal rules only "when the scheme in question evidences a distinct need for nationwide legal standards," or when Congress has made the applicable policy decision itself in an analogous statutory scheme. *Kamen v. Kemper Financial Servs., Inc.*, 111 S. Ct. at 1717 (citing cases). "Otherwise, . . . federal courts should 'incorporat[e] [state law] as the federal rule of decision,' unless 'application of [the particular] state law [in question] would frustrate specific objectives of the federal programs.'" *Ibid.* (quoting *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 728 (1979)). And the "presumption that state law should be incorporated into federal common law is particularly strong in areas in which private parties have entered legal relationships with the expectation that their rights and obligations would be governed by state-law standards." *Kamen*, 111 S. Ct. at 1717.

Here, there is no justification for a special national rule governing the right of the FDIC to bring malpractice suits against law firms that represented failed savings banks. Such lawsuits at their heart involve the lawyer-client relationship, which is a matter chiefly of concern to the individual states. No policy reflected in any pertinent federal statute suggests that there is an overriding federal interest in assuring national uniformity in this

area. Nor, more specifically, can it be said that it would frustrate achievement of federal objectives to follow the California rule that "[a] receiver occupies no better position than that which was occupied by the . . . party for whom he acts . . . and any defense good against the original party is good against the receiver." *Allen v. Ramsay*, 4 Cal. Rptr. 575, 583 (Ct. App. 1960). That, after all, is the usual rule, reflected in numerous federal cases holding that the FDIC merely "stands in the shoes" of a failed bank. *See FDIC v. Ernst & Young*, 967 F.2d at 169-70 (citing cases).

The Ninth Circuit simply ignored this straightforward, traditional analysis and chose instead to fashion its own rule, based on its notions of "equity." To support its approach, the court reflexively cited the decision in *D'Oench, Duhme & Co.*, where this Court applied federal common law in holding that the FDIC is not bound by secret side agreements between banks and borrowers. But the justification for federalizing the law in the *D'Oench, Duhme* context is inapplicable here. The key federal policy underlying that decision—the need to preserve the FDIC's ability to rely on a bank's records in making often hasty evaluations of bank assets, *see Langley v. FDIC*, 484 U.S. 86, 91 (1987)—has no relation to a case involving a potential tort claim that a bank never asserted.[12] In short, the *D'Oench, Duhme* doctrine has no more relevance here than it had in the numerous analogous cases where courts have rejected the FDIC's efforts to displace well-settled state law defenses in favor of a more accommodating federal rule. *See, e.g., FDIC v. Aetna Casualty & Sur. Co.*, 947 F.2d 196, 201-09 (6th Cir. 1991) (finding state law applicable against FDIC on insurer's defenses of adverse agency, fraud in the inducement and alter ego); *FDIC v. Bowles Livestock Comm'n Co.*, 937 F.2d 1350, 1353-56 (8th Cir. 1991) (holding FDIC may not "trump the ordinary operation of state laws"; state law defenses "control[] as the source of the federal law in this case"); *FDIC v. Harrison*, 735 F.2d 408, 412 (11th Cir. 1984) ("We see no reason not to apply the traditional rules of equitable estoppel to the conduct of FDIC in this case.").

[12] Obviously, unlike in *D'Oench, Duhme* where there was an issue of the FDIC's reliance on a fixed, contractually based asset, here the FDIC could not have relied on the specific value of a potential tort claim against O'Melveny.

In fact, as the Ninth Circuit's own decision reflects, there is no policy that would justify exempting the FDIC from most defenses previously applicable to a failed bank, other than a naked desire to maximize the assets available to the FDIC. *See* Pet. App. 15a (citing need to avoid "diminishing the value of the asset pool held by the receiver"). That can hardly be enough, in the complete absence of congressional action, to override the usual rule supplied here by state law—the rule that a receiver inherits the rights and liabilities of the entity that is taken over. Were it sufficient, all state-law impediments to maximizing the FDIC's recovery—*e.g.*, statutes of limitations, laches, comparative fault—would be swallowed by this asset-maximization policy.

This conclusion is particularly compelling given the consequences of ignoring state law in these circumstances. The clear effect of the Ninth Circuit's decision is a retroactive impact on the relationship between lawyers and their clients. Thus, even assuming that O'Melveny could have anticipated the Ninth Circuit's rather novel conclusion that California law required it to take all reasonable steps to discover its clients' fraudulent activities and to disclose that fraud to the client, the law firm would also have known that the client itself—*i.e.*, the bank—was barred from bringing a tort suit charging a breach of any such duty. Suddenly, however, as soon as the FDIC acquired ADSB's rights and liabilities, according to the Ninth Circuit, O'Melveny's defense evaporated.

This is not a sensible way for the federal scheme to operate. *See United States v. Kimbell Foods, Inc.*, 440 U.S. at 728-29 ("[O]ur choice-of-law inquiry must consider the extent to which application of a federal rule would disrupt commercial relationships predicated on state law."). At minimum, it should be up to Congress to make the kinds of pure policy determinations that evidently motivated the Ninth Circuit in this case to stretch to find a way to enrich the FDIC's coffers by allowing this action to proceed.

B. The Ninth Circuit went even further astray when it failed to focus on California law in rendering its alternative holding that even ADSB would not have been estopped from suing O'Melveny. Assuming (contrary to the Ninth Circuit's other main holding) that the FDIC does "stand in the shoes" of the failed bank, then a determination of the FDIC's rights requires the court to posit a lawsuit between the bank and its former counsel. In such a lawsuit between two private parties, there would be no basis for preempting state tort law and applying *federal* estoppel principles. Certainly the mere prospect of later FDIC involvement cannot mean that all of a bank's dealings with lawyers and other third parties affect "uniquely federal concerns" justifying displacement of state law in litigation between such private parties. *See Boyle v. United Technologies Corp.*, 487 U.S. 500, 504-07 (1988); *Miree v. DeKalb County*, 433 U.S. 25, 32-33 (1977).

It follows that, when the FDIC does become involved in litigation as the receiver of a failed savings bank, state law should still be applied in determining what rights the bank had prior to the receivership. It would make no sense to adopt a rule that the FDIC inherits the rights and liabilities of the bank and then to apply a special federal rule of decision to determine retroactively what those rights and liabilities were. In sum, when the Ninth Circuit sought to establish what rights ADSB would have

had in a suit against petitioner, there was no justification for resolving that question on the basis of anything other than California law, which guided O'Melveny during its employment and will continue to guide other California lawyers while their bank clients are solvent. California law unmistakably provides that ADSB could not pursue an action against O'Melveny.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
NINTH CIRCUIT

No. 90-55769

FEDERAL DEPOSIT INSURANCE CORPORATION, as Receiver; AMERICAN DIVERSIFIED SAVINGS BANK; ADC FINANCIAL CORP.; AMERICAN DIVERSIFIED WELLS PARK III, *et al.*,
Plaintiffs-Appellants,

v.

O'MELVENY & MYERS,
Defendant-Appellee.

Appeal from the United States District Court
for the Central District of California

Argued and Submitted July 12, 1991

Decided June 29, 1992

Before: POOLE, KOZINSKI, and LEAVY, Circuit Judges.

POOLE, Circuit Judge:

The Federal Deposit Insurance Corporation ("FDIC"), as receiver for the failed savings and loan association American Diversified Savings Bank ("ADSB"), sued the law firm of O'Melveny & Meyers ("O'Melveny" or "the Firm") claiming professional negligence in connection

with its legal advice and services to ADSB. After reviewing *de novo* the district court's grant of O'Melveny's summary judgment motion, we reverse and remand to the district court for further proceedings.

I

Facts and Procedural History [1]

ADSB was acquired in 1983 by Ranbir Sahni and Lester Day. Sahni served as Chairman and Chief Executive Officer of ADSB, and Day was its President. ADSB's principal activity was the purchase, development and sale of real estate through limited partnerships sponsored by ADSB and its subsidiaries. These activities were funded by ADSB's insured deposits, which totaled $958 million by December, 1985. ADSB's deposits were insured by what was then known as the Federal Savings and Loan Insurance Corporation ("FSLIC").[2]

In September, 1985, ADSB retained O'Melveny, one of the largest and most prominent law firms in the country, to assist with two real estate syndications, Wells Park and Gateway Center. O'Melveny undertook that assistance in the preparation of two "Private Placement Memoranda" ("PPMs"), 300-page documents designed to induce outside investors to become limited partners in the two real estate deals. O'Melveny is described in the Wells Park and Gateway Center PPMs "as special counsel . . . to the General Partner and its Affiliates in connection with Federal Securities laws, Federal income tax law, and certain other matters." [Stip. ¶ 133; Exh. 65, 67.] O'Melveny wrote substantial portions of the PPMs, edited other portions and performed a due diligence review to confirm the accuracy and completeness of the PPMs' disclosures.[3]

[1] Since this is an appeal from a summary judgment order, the facts have not been developed at trial. However, the parties have stipulated to certain facts. Disputed factual assertions are noted.

[2] The Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989, Pub.L. No. 101-73, 103 Stat. 183 (1989), abolished the FSLIC and transferred its liabilities and assets to the FSLIC Resolution Fund, of which FDIC is the manager. *Id.*, § 401(a)(1); § 215(a). FDIC was substituted as a party to this case under FIRREA § 401(f)(2). The federal regulatory agency is referred to hereinafter as "FDIC."

The parties dispute whether the PPMs indicated that the success of the projects was linked to the financial and regulatory health of ADSB, and the extent to which they represented that ADSB was in sound financial and regulatory condition. There is no dispute, however, that ADSB's financial condition was in fact far from sound. The parties agree that Sahni, Day and Wyn Pope, Executive Vice President of ADSB, had intentionally and fraudulently over-valued ADSB's assets, engaged in the sham sale of assets in order to create inflated "profits," and generally "cook[ed] the books." [Stip. ¶¶ 74, 75, 94, 95, 216; Exhs. 32, 100, 101.]

In April, 1985, ADSB's officers had decided to terminate Touche, Ross & Co. as the corporation's auditor, alleging publicly that the accounting firm was "too expensive." [Stip. ¶¶ 65, 66, 71.] ADSB replaced Touche Ross with Arthur Young & Company. By October, 1985, Arthur Young began to express concerns about ADSB's financial condition. ADSB engaged yet a third accounting firm, Coopers & Lybrand, to review the Gateway Center offering. On May 3, 1985, more than five months before the private placement offerings were sold to the investor, Touche Ross had notified ADSB, Rogers & Wells (then ADSB's attorneys), and federal regulators that they believed ADSB's net worth was less than zero.

[3] The parties disagree about the precise capacity in which the Firm was h[illegible] O'Melveny argued on appeal that "special counsel" meant tax counsel and not securities counsel. FDIC offered the Declaration of Jerry W. Carlton, O'Melveny partner and "primary partner contact" with ADSB, to support FDIC's contention that the "special counsel" role encompassed substantial assistance with the preparation of the PPMs as well as tax opinions.

In September, 1985, Rogers & Wells determined that up-to-date audited financial statements for ADSB were necessary for the "Hickory Trace" Offering, a private placement it was then preparing. Audited statements were never prepared, that particular private placement never closed, and ADSB completed the transfer of its business from Rogers & Wells to O'Melveny.

In the course of preparing the Gateway Center PPM, O'Melveny never communicated with Arthur Young, Touche Ross, Rogers & Wells, or ADSB's federal or state regulators. Nor did O'Melveny ever communicate with Day, Pope or James Miller, ADSB's Chief Financial Officer. Indeed, Arthur Young was not aware that O'Melveny had included Arthur Young's March 31, 1985 audited financial statement, by then almost six months out of date, in the Gateway Center PPM. The Wells Park and Gateway Center offerings closed on December 31, 1985.

On February 14, 1986, FDIC stepped in as conservator for ADSB, having concluded that ADSB was insolvent and that the corporation had incurred a substantial dissipation of assets and earnings due to its violations of laws and regulations and its unsafe and unsound business practices. On February 19, 1986, FDIC, as conservator for ADSB, filed a lawsuit in the Central District of California alleging breach of fiduciary duty against Sahni and Day, and RICO violations against Sahni.

Shortly after FDIC took over, it began receiving complaints from investors claiming they had been misled by the PPMs and demanding the return of their investments. FDIC, having made its own finding that the PPMs were misleading, offered to have the partnerships that controlled Wells Park and Gateway Center rescind the investments. The rescission was funded by a loan from American Diversified Capital Corporation (ADCC), a wholly-owned subsidiary of ADSB, to the offering partnerships. In accepting the rescission offer, each investor

assigned to FDIC "all actions, causes of actions, claims, or suits of any kind or nature whatsoever against any person or entity arising from the Initial Offering. . . ." [Offer of Rescission, Exh. 99] On May 12, 1989, FDIC commenced this suit against O'Melveny, charging the Firm with professional negligence, negligent misrepresentation, and breach of fiduciary duty.

At a settlement conference, the parties agreed to stipulate to a single set of facts and to test their legal claims in a summary judgment motion. O'Melveny argued before the district court that (1) it owed no duty to ADSB or its affiliates to ferret out ADSB's own fraud; (2) the conduct of ADSB's wrongdoing officers must be imputed to ADSB, and that FDIC, as receiver, stood in the shoes of ADSB; (3) and that therefore, as an ordinary assignee, FDIC was barred from pursuing any claims against O'Melveny. O'Melveny also argued that the investors' claims had been extinguished by repayment and that the investors' claims were barred by California's statute of frauds. The district court, specifying only that it perceived the existence of no genuine issue of material fact, granted O'Melveny's motion for summary judgment. FDIC appealed. We reverse.

II

Standard of Review

A trial judge should grant summary judgment under Fed.R.Civ.P. 56(c) if "there is no genuine issue as to any material fact and . . . the moving party is entitled to judgment as a matter of law." *Id.; see also Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249, 106 S.Ct. 2505, 2510, 91 L.Ed.2d 202 (1986) ("[A]t the summary judgment stage the judge's function is not himself to weigh the evidence and determine the truth of the matter but to determine whether there is a genuine issue for trial.").

We review *de novo* the district court's grant of summary judgment. *See, e.g., Kruso v. International Tel. & Tel. Corp.,* 872 F.2d 1416, 1421 (9th Cir.1989), *cert. denied,* 496 U.S. 937, 110 S.Ct. 3217, 110 L.Ed.2d 664 (1990). The evidence must be viewed in the light most favorable to the nonmoving party to determine whether there are any genuine issues of material fact for trial, and whether the district court correctly applied the relevant substantive law. *Gizoni v. Southwest Marine, Inc.,* 909 F.2d 385, 387 (9th Cir.1990), *aff'd,* — — U.S. ——, 112 S.Ct. 486, 116 L.Ed.2d 405 (1991).

III

The Duty of Care

O'Melveny must have violated a duty in order to be found negligent. The Firm concedes the existence of a duty by a principal and its agent of complete and accurate disclosure to potential investors in a securities offering, but argues that the investors here have all been fully compensated, and that the agent owes no additional duty to the successor in interest of a principal to make inquiries and disclose information which, the Firm argues, the principal already knew and was trying to conceal. In other words, O'Melveny contends that the federal agency created by Congress to rescue the economy and the victims of failing thrifts can claim no stronger ethical position than did the wrongdoers within that corporate entity; that the government agency is subject to all defenses that might lie as between the wrongdoers themselves and those who may have aided and abetted them in bringing about the disaster. We find such a proposition incredible, particularly when applied to the duties of attorneys retained to give advice and assistance with respect to public offerings.

Our starting point is the basic proposition that in general, "it is an attorney's duty to 'protect his client in every

possible way. . . .'" *Day v. Rosenthal,* 170 Cal.App.3d 1125, 1143, 217 Cal.Rptr. 89, 99 (1985) (citations omitted), *cert. denied,* 475 U.S. 1048, 106 S.Ct. 1267, 89 L.Ed.2d 576 (1986). Attorneys fulfill this duty by performing the legal services for which they have been engaged with "such skill, prudence and diligence as lawyers of ordinary skill and capacity commonly possess. . . ." *Id., quoting Lucas v. Hamm,* 56 Cal.2d 583, 591, 15 Cal.Rptr. 821, 825, 364 P.2d 685, 689 (1961), *cert. denied,* 368 U.S. 987, 82 S.Ct. 603, 7 L.Ed.2d 525 (1962).[4]

Furthermore, if an attorney "specializes within the profession, he must meet the standards of knowledge and skill of such specialists." *Neel v. Magana, Olney, Levy, Cathcart & Gelfand,* 6 Cal.3d 176, 188, 98 Cal.Rptr. 837, 844, 491 P.2d 421, 428 (1971). An attorney's failure to perform in accordance with his duty is negligence, because "[e]ven as to doubtful matters, an attorney is expected to perform sufficient research. . . ." *Smith v. Lewis,* 13 Cal.3d 349, 360, 118 Cal.Rptr. 621, 628, 530 P.2d 589, 596 (1975), *overruled on other grounds, In re Marriage of Brown,* 15 Cal.3d 838, 126 Cal.Rptr. 633, 544 P.2d 561 (1976); *Day v. Rosenthal,* 170 Cal.App.3d at 1146-47, 217 Cal.Rptr. 89.

O'Melveny's position is that a lawyer owes no duty to uncover a client's fraud nor to advise the client and the world of that fraud. The Firm points out that Cali-

[4] *See also* California Supreme Court, *Rules of Professional Conduct* (1989), *reprinted in Selected Standards on Professional Responsibility* (D. Morgan & R. Rotunda, eds. 1991): "To perform legal services competently means diligently to apply the learning and skill necessary to perform the [attorney's] duties arising from employment or representation." *Id.* at 246. While professional standards are not meant to give rise to civil liability, we find that "[t]he attempt to deny that there is anything in these codes of conduct that is relevant to the legal duty owed by a lawyer to his client is simply breathtaking. It is also quite wrong." A. Kaufman, *Problems in Professional Responsibility* 662 (3d ed. 1989).

fornia has recently reiterated its traditionally narrow construction of attorney malpractice exposure under California law. *See Kimmel v. Goland,* 51 Cal.3d 202, 213-14 n. 10, 271 Cal.Rptr. 191, 198 n. 10, 793 P.2d 524, 531 n. 10 (1990); *Skarbrevik v. Cohen, England & Whitfield,* 231 Cal.App.3d 692, 701-707, 282 Cal.Rptr. 627, 633-37 (1991). There are two problems with O'Melveny's approach. The first is the implication that if the client happens to be committing a fraud, of which the attorney may or may not be aware, the presence of the fraud cancels the attorney's duty to use due care. No California cases advise us of an exception to the general rule that a lawyer has to act competently to avoid public harm when he learns that his is a dishonest client. The *Skarbrevik* and *Kimmel* cases merely decline to expand this duty of attorneys; they do not create any exceptions to it.

The second problem with O'Melveny's approach is its sharp differentiation between a "duty to investors," which it concedes, and a "duty to the client," which it denies. Given a broad duty to protect the client, this distinction is a false one. Part and parcel of effectively protecting a client, and thus discharging the attorney's duty of care, is to protect the client from the liability which may flow from promulgating a false or misleading offering to investors. An important duty of securities counsel is to make a "reasonable, independent investigation to detect and correct false or misleading materials." *Felts v. National Account Sys. Assoc., Inc.,* 469 F.Supp. 54, 67 (N.D.Miss.1978). This is what is meant by a due diligence investigation. *Koehler v. Pulvers,* 614 F.Supp. 829, 845 (S.D.Cal.1985) (due diligence required lawyer's independent investigation of information supplied by issuer for incorporation into offering materials). The Firm had a duty to guide the thrift as to its obligations and to protect it against liability. In its high specialty field, O'Melveny owed a duty of due care not only to the investors, but also to its client, ADSB.

O'Melveny asserts that the Firm's attorneys "were deeply concerned with the proper portrayal of ADSB in the Gateway Center and Wells Park PPMs." FDIC's expert witness, Alan Berkeley, testified that in the circumstances of this case, fundamental due care required O'Melveny to contact Arthur Young, Touche Ross, and Rogers & Wells prior to signing and releasing the PPMs. The reasons for O'Melveny's lack of success in designing an accurate offering document constitute a triable issue of fact. Were a subsequent trier of fact to determine that O'Melveny had indeed been negligent, the Firm's negligence would not be based upon its declination to "ferret out fraud", but rather because it failed to make a reasonable, independent investigation. As one commentator has explained:

> [A]ttorneys, in rendering opinions relating to the securities laws, are not justified in assuming facts as represented to them by the client and in basing their opinion on the assumption that such facts are correct. Rather . . . the attorney must make a reasonable effort to independently verify the facts on which the opinion is based.

H. Bloomenthal, *Securities Law Handbook,* § 27.02 at 1096 (1990-91 ed.).

IV

Estoppel

Given a basic duty to give proper advice to the client who is asking the public to invest in its offerings, the next inquiry is whether the attorneys are absolved of that duty if there were wrongdoing officers inside the corporation. O'Melveny argues that the acts of the wrongdoing officers are attributable to the corporation itself, and because FDIC "stands in the shoes" of the corporation as its receiver, by transference, FDIC is entitled to no more than the wrongdoing officers themselves would have been. Under this argument, FDIC would be estopped

from making a claim against O'Melveny by the wrongdoing of the corporate insiders. We disagree with this flat statement of the law, particularly in view of the public expectation that the wrongdoing will be exposed, the wrongdoers pursued, and the innocent victims of fraud will have a chance at recovering.

A

The Thrift's Corporate Identity

O'Melveny bases its position on the unexceptionable general principle that the perpetrator of a fraud cannot be a victim of that fraud. ADSB has no identity separate from that of Sahni and Day, argues O'Melveny, and Sahni and Day as wrongdoers could not have been victimized by O'Melveny's supposed negligence. O'Melveny asserts that "even if it were careless," FDIC cannot pursue a claim against O'Melveny because FDIC stands in the shoes of the wrongdoers at ADSB, and FDIC's claims for relief are "barred by the plaintiff's unclean hands."

We thus begin this section of our inquiry with the issue of ADSB's corporate identity. Could this case, as O'Melveny has urged, have just as appropriately been entitled "Sahni and Day v. O'Melveny & Meyers"?

ADSB was the client here, not Sahni and Day. The misconduct of ADSB insiders provides O'Melveny with a defense only if the insiders' knowledge could be attributed to ADSB. Because these wrongdoers were acting adversely to ADSB and not on its behalf, principles of corporate identity and agency law preclude attribution, starting with the basic distinction between a corporation and its stockholders. "It is fundamental, of course, that a 'corporation is a distinct legal entity separate from its stockholders and from its officers.'" *Merco Constr. Eng'rs v. Municipal Court,* 21 Cal.3d 724, 729, 147 Cal.Rptr. 631, 634, 581 P.2d 636, 639 (1978) (citations omitted). This rule applies even when, as here, a single individual

owns nearly all of the corporation's stock. *In re John Koke Co.,* 38 F.2d 232, 233 (9th Cir.1930) *cert. denied sub nom. A.R. Demory Invest. Co. v. Haese,* 282 U.S. 840, 51 S.Ct. 21, 75 L.Ed. 746 (1930); *Potts v. First City Bank,* 7 Cal.App.3d 341, 345-46, 86 Cal.Rptr. 552, 555 (1970).[5]

We next inquire whether Sahni and Day's wrongdoing as corporate *officers* can appropriately be attributed to ADSB.[6] "Generally the knowledge of a corporate officer within the scope of his employment is the knowledge of the corporation. . . . [, however,] the knowledge acquired by the agent who is acting adversely to his principal will not be attributed to the principal." *Meyer v. Glenmoor Homes, Inc.,* 246 Cal.App.2d 242, 264, 54 Cal. Rptr. 786, 800-801 (1967) (citations omitted); *see also In re Investors Funding Corp.,* 523 F.Supp. 533, 540-41 (S.D.N.Y.1980) (holding that the misconduct of officers is not attributable to the corporation); *Holland v. Arthur Andersen & Co.,* 127 Ill.App.3d 854, 862-68, 82 Ill.Dec. 885, 890-94, 469 N.E.2d 419, 424-28 (1984) (sustaining an insurance company's malpractice claim against a debtor company's auditors, the court held that there could be no attribution of the knowledge of the debtor company's wrongdoers to the corporation because the wrongdoers were acting against the interests of the corporation).

The cases of *Schacht v. Brown,* 711 F.2d 1343 (7th Cir.1983), *cert. denied,* 464 U.S. 1002, 104 S.Ct. 509, 78 L.Ed.2d 698 (1983); *Cenco, Inc. v. Seidman & Seidman,* 686 F.2d 449 (7th Cir.1982), *cert. denied,* 459 U.S. 880, 103 S.Ct. 177, 74 L.Ed.2d 145 (1982); and

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[5] *Meehan v. Hopps,* 144 Cal.App.2d 284, 301 P.2d 10 (1956) is not to the contrary. That case actually held that corporate counsel do not have an attorney-client relationship with the corporation's shareholders. *See id.* at 293, 301 P.2d at 15. Subsequent California cases follow the holding in *Meehan. See, e.g., Ward v. Superior Court,* 70 Cal.App.3d 23, 32-33, 138 Cal.Rptr. 532, 537 (1977).

[6] Sahni and Day played two roles in relation to the corporation: as shareholders and as directors.

Investors Funding all turn on whether a corporate plaintiff (or, as here, its receiver) is estopped from recovering for the defendant's breach of duty because of the fraud of insiders. The holdings in *Schacht* (followed by this Circuit in *Kempe v. Monitor Intermediaries, Inc.*, 785 F.2d 1443, 1444 (9th Cir.1986)), *Cenco* and *Investors Funding* determine that there can be no attribution, and therefore no estoppel, when the insiders, rather than the corporation, benefit from the wrongdoing. *Schacht* at 1348; *Cenco* at 454-56; *Investors Funding* at 541.

Here, disaster, not benefit, accrued to ADSB through the malfeasance of Sahni, Day and Pope. *Schacht* and *Investors Funding* elaborate that conduct aggravating a corporation's insolvency and fraudulently prolonging its life does not benefit that corporation. Indeed, under *Schacht,* even if the corporation were somehow to benefit from the wrongdoing of insiders, the insiders' conduct is still not attributable to the corporation if a recovery by the plaintiff would serve the objectives of tort liability by properly compensating the victims of the wrongdoing and deterring future wrongdoing. 711 F.2d at 1348; *accord, Cenco,* 686 F.2d at 455; *see also Lincoln Sav. & Loan Ass'n v. Wall,* 743 F.Supp. 901 (D.D.C.1990); *Diamond Mortgage Corp. v. Sugar,* 913 F.2d 1233, 1247-48 (7th Cir.1990) (applying *Investors Funding* to legal malpractice claims of corporations in bankruptcy against their pre-bankruptcy attorneys), *cert. denied,* —— U.S. ——, 111 S.Ct. 968, 112 L.Ed.2d 1054 (1991).[7]

Furthermore, we note that O'Melveny cannot invoke an estoppel defense unless it is innocent itself. *See, e.g., Meyers v. Moody,* 693 F.2d 1196, 1208 (5th Cir.1982) ("A party may not invoke an estoppel for the purpose of

[7] *Blain v. Doctor's Company,* 222 Cal.App.3d 1048, 1062, 272 Cal.Rptr. 250 (1990) is not to the contrary. There, a client was held to have "no cause of action for injury caused by his own misconduct," *id.* at 1062, 272 Cal.Rptr. at 258, whereas in the present case, we determine that attribution of the insider's wrongdoing to FDIC is inappropriate.

shielding himself from the results of his own fraud, dereliction of duty, or other inequitable conduct."), *cert. denied,* 464 U.S. 920, 104 S.Ct. 287, 78 L.Ed.2d 264 (1983).[8] We conclude that ADSB has a corporate identity distinct from that of its wrongdoing officers.

B

Role and Rights of FDIC

Even assuming Sahni and Day's knowledge would be imputed to ADSB so that ADSB would be estopped from bringing this lawsuit, this does not answer the question whether FDIC as receiver is estopped; there remains the problem of asserting against ADSB's successor an equitable defense that is good against ADSB. O'Melveny argues that under well-established California law, "[a] receiver occupies no better position than that which was occupied by the . . . party for whom he acts . . . and any defense good against the original party is good against the receiver." *Allen v. Ramsay,* 179 Cal.App.2d 843, 854, 4 Cal. Rptr. 575 (1960). Thus, if O'Melveny can raise an equitable estoppel defense against ADSB, it can raise it against receiver FDIC as well.

The flaw in this argument is the law O'Melveny assumes applies. It is by now clear beyond doubt that federal, not state, law governs the application of defenses against FDIC.[9] While we may incorporate state law to

[8] We are unpersuaded by O'Melveny's contrary citation to *McKenney v. Ellsworth,* 165 Cal. 326, 132 P. 75 (1913). The exception from *McKenney* does not apply because O'Melveny is not an innocent third party in this case. Cases where innocent victims of an agent's wrongdoing sue the principal are inapposite in this context. *See, e.g., Warshauer v. Bauer Constr. Co.,* 179 Cal.App.2d 44, 3 Cal.Rptr. 570 (1960); *Maron v. Swig,* 115 Cal.App.2d 87, 251 P.2d 770 (1952).

[9] *See D'Oench, Duhme & Co. v. FDIC,* 315 U.S. 447, 456, 62 S.Ct. 676, 679, 86 L.Ed. 956 (1942); *FDIC v. Bank of San Francisco,* 817 F.2d 1395, 1398 (9th Cir.1987); *see also FDIC v. Mmahat,*

provide the federal rule of decision, we are not bound to do so. *See FDIC v. New Hampshire Ins. Co.*, 953 F.2d 478, 481 (9th Cir.1991), *amended*, 953 F.2d 478 (9th Cir.1992). Thus, contrary to O'Melveny's argument, we are not bound by state law, but must instead establish federal law.

In fashioning a federal rule of decision, we are guided by the age-old principles that equity does equity, *see Van Rensselaer v. Kearney*, 52 U.S. (11 How.) 297, 325, 13 L.Ed. 703 (1850), and that "[e]quity will look through the form of the transaction, and adjust the equities of the parties with a view to its substance, ..." *Drexel v. Berney*, 122 U.S. 241, 254, 7 S.Ct. 1200, 1205, 30 L.Ed. 1219 (1887) (internal quotations omitted). These principles lead us to conclude that equitable defenses good against a bank do not carry over against the bank's receiver.

A receiver, like a bankruptcy trustee and unlike a normal successor in interest, does not voluntarily step into the shoes of the bank; it is thrust into those shoes. It was neither a party to the original inequitable conduct nor is it in a position to take action prior to assuming the bank's assets to cure any associated defects or force the bank to pay for incurable defects. This places the receiver in stark contrast to the normal successor in interest who voluntarily purchases a bank or its assets and can adjust the purchase price for the diminished value of the bank's assets due to their associated equitable defenses. In such cases, the bank receives less consideration for its assets because of its inequitable conduct, thus bearing the cost of its own wrong.

Also significant is the fact that the receiver becomes the bank's successor as part of an intricate regulatory scheme designed to protect the interests of third parties

907 F.2d 546, 550 (5th Cir.1990), *cert. denied*, —— U.S. ——, 111 S.Ct. 1387, 113 L.Ed.2d 444 (1991); *FDIC v. Gulf Life Ins. Co.*, 737 F.2d 1513, 1517 (11th Cir.1984).

who also were not privy to the bank's inequitable conduct. That scheme would be frustrated by imputing the bank's inequitable conduct to the receiver, thereby diminishing the value of the asset pool held by the receiver and limiting the receiver's discretion in disposing of the assets. *See Gulf Life*, 737 F.2d at 1517; *cf. Langley v. FDIC*, 484 U.S. 86, 91-92, 108 S.Ct. 396, 401-02, 98 L.Ed.2d 340 (1987).

In light of these considerations, we conclude that the equities between a party asserting an equitable defense and a bank are at such variance with the equities between the party and a receiver of the bank that equitable defenses good against the bank should not be available against the receiver. To hold otherwise would be to elevate form over substance—something courts sitting in equity traditionally will not do. *See Drexel*, 122 U.S. at 254, 7 S.Ct. at 1205. Of course, it does not necessarily follow that equitable defenses can never be asserted against FDIC acting as a receiver; we hold only that the bank's inequitable conduct is not imputed to FDIC.

V

The Measure of Damages

If FDIC is successful in this case, the appropriate measure of damages would be the out of pocket costs to the client properly attributable to the fraudulent transaction. This would include a denial of O'Melveny's cross-claim for its fees, rescission of any fees paid to O'Melveny, settlement costs, brokers' commissions, and any losses on property purchased as a result of the offerings having closed, provided such losses can be documented with the requisite level of certainty at trial. FDIC is not seeking reimbursement for the rescission payments to the investors, which were underwritten by a subsidiary of ADSB.

VI

Conclusion

We hold that O'Melveny owed a duty of care to its client ADSB and that there are genuine disputes of material fact as to whether that duty was discharged. The case is yet to be tried; we do not assume how the dispute will eventually be resolved, but we find there to be issues for trial. We also hold that FDIC, acting as an involuntary successor in interest pursuant to a federal regulatory scheme, is not estopped from litigating its claims against O'Melveny because of the "unclean hands" of the ADSB insiders. The judgment of the district court which held as a matter of law that no issues of material fact could be proved because FDIC has no standing is erroneous and therefore that judgment is hereby REVERSED and REMANDED for further proceedings consistent with this opinion.

APPENDIX B

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

Case No. CV 89-2877 TJH (Kx)

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION, as Receiver for AMERICAN DIVERSIFIED SAVINGS BANK, *et al.*,

Plaintiffs,

vs.

O'MELVENY & MYERS, a law partnership,

Defendant.

O'MELVENY & MYERS, a law partnership,

Counterclaimant,

vs.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION, as Receiver for AMERICAN DIVERSIFIED SAVINGS BANK and ADC FINANCIAL CORPORATION,

Counterdefendants.

LOS ANGELES, CALIFORNIA

MONDAY, APRIL 9, 1990, 10:00 A.M.

THE COURT CLERK: Item No. 5, Civil Action, CV 89-02877-TJH, FDIC, etc., versus O'Melveny & Myers.

Counsel, make your appearances, please.

MR. SMITH: Good morning, Your Honor.

Gregory Smith and Sarah Lipscomb with the law firm of Irell and Manella, representing the defendant and moving party O'Melveny & Myers.

THE COURT: Thank you, both.

MR. RUSSELL: Good morning, your honor.

Theodore Russell and Sharon O'Grady of Pettit and Martin for the plaintiff Federal Deposit Insurance Corporation.

THE COURT: Thank you.

Does anyone have something to add to their papers that were inadvertently left out?

MR. SMITH: Your Honor, that is always a hard question.

THE COURT: Not really.

Did you leave something out of your papers?

MR. SMITH: No, Your Honor. I don't think we did leave anything out of our papers.

I think the key issue here is a very clear one.

And that is whether the knowledge of Messrs. Sauny and Day (Phonetic) are to be imputed to the corporation, And I think on that issue we have made our position very clear, and that that takes care of the entire question of whether ADSB has a cause of action against O'Melveny and Myers.

On the second major portion of the case, which is the cause of action of the investors, I again think our papers are quite clear that no such claim can any longer be presented.

THE COURT: All right.

Does Any one else wish to be heard?

MR. RUSSELL: We have nothing to add to our papers, Your Honor.

THE COURT: All right.

Well, I think it is fairly clear that the purpose of the Securities Act is to compel full and fair disclosure but two of the investors, and knowing that the investors have

been protected here since, indeed, there has been the repayment, we no longer have a problem as far as O'Melveny is concerned.

They owe no duty to any one other, so I am going to grant their motion for summary judgment.

We will need an order.

Will you prepare that order, then, Mr. Smith?

MR. SMITH: Yes, I will, Your Honor.

Thank you, very much.

THE COURT: All right.

Thank you.

(The proceedings were concluded.)

APPENDIX C

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

Case No. CV 89-2877 TJH (Kx)

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION, as Receiver for AMERICAN DIVERSIFIED SAVINGS BANK, *et al.*,
Plaintiffs,

vs.

O'MELVENY & MYERS, a law partnership,
Defendant.

O'MELVENY & MYERS, a law partnership,
Counterclaimant,

vs.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION, as Receiver for AMERICAN DIVERSIFIED SAVINGS BANK and ADC FINANCIAL CORPORATION,
Counterdefendants.

[PROPOSED]
ORDER GRANTING
SUMMARY JUDGMENT

[Filed May 15, 1990]

ORDER

The motion of defendant O'Melveny & Myers ("O'Melveny") for Summary Judgment in its favor on the Complaint herein came on regularly for hearing on April 9,

1990, before The Honorable Terry J. Hatter, Judge of the United States District Court. Theodore Russell and Sharon O'Grady of Pettit & Martin appeared as attorneys for the plaintiffs, and Gregory R. Smith and Sara D. Lipscomb of Irell & Manella appeared as attorneys for defendant.

After full consideration of the evidence and points and authorities submitted by the parties, and after the opportunity of oral argument, the Court finds that O'Melveny has shown by admissible evidence and reasonable inferences therefrom, not controverted by other evidence or inferences, that none of the causes of action in the Complaint has merit, that there is no genuine dispute or triable issue as to any material fact, that O'Melveny is entitled to judgment in its favor with respect to the Complaint as a matter of law, and that there is no just reason for delay with respect to entry of judgment. Accordingly,

IT IS ORDERED that O'Melveny's Motion for Summary Judgment be, and hereby is, granted in favor of O'Melveny and against plaintiffs, that the Complaint against O'Melveny is accordingly dismissed with prejudice, that pursuant to Rule 54(d) of the Federal Rules of Civil Procedure judgment should be entered at this time, and that defendant is entitled to costs herein.

DATED: May 15, 1990.

/s/ Terry J. Hatter, Jr.
TERRY J. HATTER
United States District Judge

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 90-55769

D.C. No. CV-89-2877-TJH

FEDERAL DEPOSIT INSURANCE CORPORATION, as Receiver; AMERICAN DIVERSIFIED SAVINGS BANK; ADC FINANCIAL CORP.; AMERICAN DIVERSIFIED WELLS PARK II, *et al.*, *Plaintiffs-Appellants,*

v.

O'MELVENY & MYERS,
Defendants-Appellees.

ORDER

[Filed June 30, 1993]

Before: POOLE, KOZINSKI and LEAVY, Circuit Judges.

The panel has voted to deny the petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc and no active judge has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.